

**Before the  
Federal Communications Commission  
Washington, D.C. 20554**

In the Matter of	)	
	)	
Valor Telecommunications of Texas and Valor	)	
Telecommunications of New Mexico Petition for	)	WCB/Pricing File No. 02-11
Waiver of the Operation of the X-factor in the	)	
Price Cap Indices Formula Set Forth in	)	
§ 61.45(b)(1)(i)	)	

**ORDER**

**Adopted: June 6, 2002**

**Released: June 7, 2002**

By the Chief, Wireline Competition Bureau:

**I. INTRODUCTION**

1. In this order, we address the petition filed by Valor Telecommunications of Texas, L.P. (Valor Texas) and Valor Telecommunications of New Mexico, LLC (Valor New Mexico) (collectively Valor) seeking waiver of the application of the X-factor in the price cap indices formula set forth in section 61.45(b)(1)(i) of the Commission's rules.<sup>1</sup> For the reasons discussed below, we grant limited relief to Valor Texas and deny relief to Valor New Mexico. Specifically, we will defer the application of the (X – GDP-PI) portion of the price cap indices formula for Valor Texas until 2004.

**II. BACKGROUND**

2. In May 2000, the Commission adopted an integrated interstate access reform and universal service proposal for price cap local exchange carriers (LECs).<sup>2</sup> Pursuant to the *CALLS Order*, LECs were required to choose between the rates adopted in the *CALLS Order* for the five-year term of the CALLS plan or reinitialized rates based on forward-looking economic cost.<sup>3</sup> Carriers that elected the CALLS plan subject their interstate average traffic sensitive (ATS) access rates to an X-factor of 6.5 percent until certain target rates are reached.<sup>4</sup> Pursuant to the *CALLS Order*, the target rate for ATS charges for primarily rural LECs is 0.95 cents.<sup>5</sup> Once the ATS target rate is reached, the 6.5 percent X-factor is applied to reduce carrier

<sup>1</sup> 47 C.F.R. § 61.45(b)(1)(i).

<sup>2</sup> See *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order, 15 FCC Rcd 12962, 12964, para.1 (2000) (*CALLS Order*).

<sup>3</sup> *Id.* at 12974, 12984, paras. 29 and 57.

<sup>4</sup> *Id.* at 13028, para. 161.

<sup>5</sup> See *id.* at 13029, para. 163.

common line (CCL) charges.<sup>6</sup> After the elimination of the CCL charges, or on June 30, 2004 (X-factor free year), whichever comes earlier, the X-factor is set to inflation.<sup>7</sup>

3. Valor purchased exchanges from the former GTE, opted into the CALLS plan, and began local exchange operations in September 2000 in Texas, New Mexico, and Oklahoma. Valor has reached the 0.95 cent target rate but has not yet eliminated its CCL charges. Consistent with the *CALLS Order*, Valor must apply the X-factor of 6.5 percent, offset by inflation, to the Common Line, Marketing, and Transport Interconnection Charge (CMT) basket, thereby reducing CMT revenues, until its CCL is eliminated.

4. On April 12, 2002, Valor filed a Petition for Waiver requesting that the X-factor not be applied in the years that the company makes a low-end adjustment pursuant to section 61.45(d)(1)(vii).<sup>8</sup> Valor claims that there is an inherent conflict between the X-factor and the low-end adjustment mechanism, and that enforcement of the X-factor yields anomalous results undermining the purpose for which the low-end adjustment was adopted.<sup>9</sup> Valor further claims that granting such waiver will not undermine the X-factor's purpose. CenturyTel, in its reply comments filed May 17, 2002, supports Valor's petition, and asks the Commission to ensure that carriers have reasonable opportunity to earn a 10.25 percent rate of return.<sup>10</sup> In its opposition, filed May 7, 2002, AT&T argues that Valor's request is "far-reaching," and such an individual exemption from the X-factor would "strike a blow to very core of the LEC price cap system."<sup>11</sup> AT&T also argues that Valor fails to provide any acceptable or verifiable evidence to support the extraordinary relief it seeks.<sup>12</sup>

### III. DISCUSSION

5. The Commission has discretion to waive a rule for "good cause" shown.<sup>13</sup> Generally, the Commission may grant a waiver of its rules where the particular facts make strict compliance inconsistent with the public interest if applied to petitioner and when the relief requested would not undermine the policy objective of the rule in question.<sup>14</sup> Petitioner must demonstrate that, in view of unique or unusual factual circumstances, application of the rule(s) would be inequitable, unduly burdensome, or contrary to the public interest.<sup>15</sup> For the reasons discussed below, we find that, although Valor has failed to show good cause for

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<sup>6</sup> *Id.* at 13022, para. 144. The Carrier Common Line (CCL) charge is a per-minute charge assessed on an end user's interexchange carrier (IXC) whenever the end user places an interstate long-distance call. See *Access Charge Reform*, CC Docket No. 96-262, Report and Order, 12 FCC Rcd 15982, 16004-16006, paras. 54-60 (1997) (*Access Charge Reform Order*). At the time of *CALLS Order*, only BellSouth, Citizens, and certain study areas served by GTE, Frontier, and Sprint collected CCL charges. See *CALLS Order*, 15 FCC Rcd at 12987, para. 68.

<sup>7</sup> 47 C.F.R. § 61.45(i)(4); *CALLS Order*, 15 FCC Rcd at 13029, para. 163. Inflation is based on the GDP-PI. See *CALLS Order*, 15 FCC Rcd at 13029, para. 163.

<sup>8</sup> Petition of Valor Telecommunications of Texas, L.P. and Valor Telecommunications of New Mexico, LLC for Waiver of Application of the X-factor as applied in Section 61.45(b)(1)(i) (Petition).

<sup>9</sup> Petition at 6-9.

<sup>10</sup> CenturyTel's Reply Comments (CenturyTel Reply).

<sup>11</sup> AT&T Opposition to Valor's Request for Waiver of the X-Factor at 2 (AT&T Opposition).

<sup>12</sup> *Id.* at 7-9.

<sup>13</sup> 47 C.F.R. § 1.3.

<sup>14</sup> *WAIT Radio v. FCC*, 418 F.2d 1153 (D.C. Cir. 1969), *appeal after remand*, 459 F.2d 1203 (D.C. Cir. 1972), *cert. denied*, 409 U.S. 1027 (1972) ("*WAIT Radio*"); *Northeast Cellular Tel. Co. v. FCC*, 897 F.2d 1164 (D.C. Cir. 1990) ("*Northeast Cellular*").

<sup>15</sup> *WAIT Radio*, 418 F.2d at 1159.

waiver of section 61.45(b)(1)(i) in every year that it makes a low-end adjustment, we do find that Valor has shown good cause for certain limited relief, described more fully below.

6. Valor claims that the operation of the X-factor is inconsistent with the low-end adjustment mechanism. We disagree. The X-factor and the low-end adjustment serve different purposes and coexist without negating each other, and such co-existence is consistent with the *CALLS Order* and the Commission's policy goals. Traditionally, the X-factor represents the amount by which LEC productivity gains can be expected to exceed productivity gains in the economy as a whole.<sup>16</sup> The *CALLS Order* altered the traditional function of the X-factor so that it now serves as a transitional mechanism to reduce certain access charges over the term of the *CALLS* plan.<sup>17</sup> The Commission has always recognized that, to the extent possible, costs of providing interstate access services should be recovered in the same way that they are incurred.<sup>18</sup> Ideally, non-traffic sensitive costs should not be recovered through usage-based rates. Because the cost of the incumbent LEC's common line does not increase with usage, the CCL, as a per-minute charge, violates this basic principle of cost causation. The Commission's access charge reforms aim at adjusting access rates over time until the common line revenues of all price cap LECs are recovered through flat-rated charges.<sup>19</sup> Moreover, to the extent that the CCL charge does not reflect the underlying cost of providing access service, it also embodies an implicit subsidy from high-volume users of interexchange services to users that make few or no long distance calls. The Commission's rules reflect a desire to eliminate such implicit subsidies from interstate access charges to the extent possible.<sup>20</sup> Application of the X-factor furthers these goals by reducing CCL charges.<sup>21</sup>

7. The low-end adjustment mechanism, on the other hand, protects LECs to some extent from events beyond their control that are likely to affect earnings to an extraordinary degree, such as local or regional recessions. The Commission recognized that failure to include any adjustment for such circumstances could harm customers because unusually low earnings over a prolonged period could threaten a LEC's ability to raise the capital necessary to provide modern, efficient services to customers.<sup>22</sup> The purpose of the low-end adjustment mechanism is not to guarantee a certain level of minimum profit for price cap LECs for an upcoming year,<sup>23</sup> but instead to allow a LEC to increase its price cap indices (PCI), and consequently its access rates, by retargeting its prior year rate of return to 10.25 percent.<sup>24</sup> Contrary to

<sup>16</sup> See, e.g., *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6796, paras. 74-75 (1990) (*LEC Price Cap Order*) and *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, 12 FCC Rcd 16642 (1997) (*X-Factor Order*) (subsequent history omitted). See also *CALLS Order*, 15 FCC Rcd 12962, 13018-13029, paras. 135-140.

<sup>17</sup> *CALLS Order*, 15 FCC Rcd at 13021, paras. 140-141. The *CALLS* plan includes two X-factors: one for switched access service and a separate X-factor for special access services. After predetermined target rates are reached, the switched access X-factor will be equal to GDP-PI; the special access X-factor will also be adjusted to GDP-PI on July 1, 2004. See *CALLS Order*, 15 FCC Rcd at 13021, paras. 140-141.

<sup>18</sup> *Access Charge Reform Order*, 12 FCC Rcd at 16004-16009, paras. 53-71.

<sup>19</sup> *Id.* at 15998-16000, paras. 36-40. See also *CALLS Order*, 15 FCC Rcd at 12969-12970, para. 18.

<sup>20</sup> See *CALLS Order*, 15 FCC Rcd at 12975, para. 31; see also *Access Charge Reform Order*, 12 FCC Rcd at 16007-16008, paras. 68-69.

<sup>21</sup> See *CALLS Order*, 15 FCC Rcd at 13014, para. 128.

<sup>22</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6804, para. 147.

<sup>23</sup> *Id.*, 5 FCC Rcd at 6804, paras. 147-148.

<sup>24</sup> Price cap indices (PCI) limit the prices carriers charge for service, and allow them to retain earnings generated through improved operating efficiencies and innovations. The PCI formula contains three components: (1) a measure of inflation (GDP-PI), (2) the X-factor, and (3) certain exogenous cost factors. The low-end adjustment is treated in PCI formulas as an exogenous cost. See 47 C.F.R. § 61.45.

Valor's and CenturyTel's understanding, 10.25 percent is not a prescribed minimum rate of return for price-cap carriers, but a low-end adjustment mark that triggers a backstop mechanism.<sup>25</sup> The Commission has never said that price cap LECs were entitled to a 10.25 percent rate of return, or that a lower return is confiscatory. In fact, because the (X – GDP-PI) element of the price cap formula is applied to the low-end adjustment, as it is to all exogenous adjustments, and because the rates are set using past, rather than actual demand, the low-end adjustment mechanism has never produced a 10.25 percent return. In addition, as AT&T points out, this system has been used by numerous carriers over the course of twelve years without challenge.<sup>26</sup>

8. The Commission intended that the X-factor mechanism operate in the years a LEC makes a low-end adjustment.<sup>27</sup> Under the *CALLS Order*, the X-factor and low-end adjustment complement each other and strike the best balance between competing interests. While the X-factor reduces CCL charges, its application does not prevent a carrier from increasing its earnings through other available means, e.g., by increasing its productivity through improved operating efficiencies and innovations. Further, in the *CALLS Order*, the Commission declined to adopt a separate X-factor for smaller price cap LECs. To accommodate smaller price cap LECs, the Commission instead relied on certain mechanisms such as the low-end adjustment and higher target rates for mid-size and very low-density price cap LECs.<sup>28</sup> Valor, in fact, proposed and supported such higher target rates and an X-factor of 6.5 percent targeting CCL charges.<sup>29</sup>

9. For these reasons, Valor is incorrect when it asserts that in July 2001 the X-factor “consumed over \$1.3 million” of its \$3.3 million low-end adjustment.<sup>30</sup> A low-end adjustment to a carrier's revenue requirement in its annual tariff filing only affects the carrier's PCI for one year, and does so to account for low earnings in the previous year. The amount of the low-end adjustment is excluded from the calculation of the current year's earnings in the carrier's next annual filing.<sup>31</sup> In Valor's case, the \$3.3 million low-end adjustment was designed to allow Valor the opportunity to adjust its rates to reflect a 10.25 percent rate of return for the previous year, 2000, before (X – GDP-PI), and it is not used to calculate Valor's rate of return for 2001. The \$1.3 million adjustment Valor describes, however, does affect earnings for 2001.

10. Valor also argues that granting a waiver of section 61.45(b)(1)(i) every time Valor makes a low-end adjustment will not undermine the purpose for which the X-factor was adopted because access rates already have declined significantly as a result of the implementation of the *CALLS Order*.<sup>32</sup> We disagree. The decline of access charges, without more, is an insufficient basis for a waiver. Valor's argument neither alleviates the concern that granting the Petition may significantly hinder elimination of the CCL charge, nor addresses the issue of how such waiver might affect achievement of the regulatory objectives reflected in the *CALLS Order*.

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<sup>25</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6804-6807, paras. 147-165; see also *CALLS Order*, 15 FCC Rcd at 13038, para. 182.

<sup>26</sup> See AT&T Opposition at 6-7.

<sup>27</sup> See *CALLS Order*, 15 FCC Rcd at 13034, para. 173.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 13020-13021, paras. 140-141. See also Letter from Anne Bingaman, Chairman and CEO, Valor Telecommunications Southwest, LLC and John T. Nakahata, Counsel for Coalition for Affordable Local and Long Distance Service, to Larry Strickling, Chief, Common Carrier Bureau, FCC (filed Apr. 14, 2000 in CC Dockets 96-262, 94-1, 96-45, 99-249).

<sup>30</sup> Petition at 7.

<sup>31</sup> See 47 C.F.R. § 61.3(g) and 47 C.F.R. § 61.45.

<sup>32</sup> Petition at 9-10.

11. As discussed above, nothing in the record demonstrates that a waiver of section 61.45(b)(1)(i) every time Valor makes a low-end adjustment is in the public interest. If Valor believes that the X-factor should never be applied when a carrier makes a low-end adjustment, then it should file a petition for rulemaking.<sup>33</sup> We consider, however, Valor's request for waiver of the X-factor for this year below, and evaluate Valor New Mexico's and Valor Texas's requests separately in determining whether they satisfy our waiver standard.

12. *Valor New Mexico.* We find that Valor New Mexico fails to show good cause for waiver of our rules. Nothing in the record demonstrates that Valor New Mexico's situation is unique, or that application of the X-factor this year would be inequitable or unduly burdensome, or contrary to the public interest. Valor New Mexico acquired two study areas, #1164 representing the former GTE-Southwest study area, and #1193 representing the former Contel study area.<sup>34</sup> Valor's study areas in New Mexico have historically earned a rate of return in excess of 10.25 percent.<sup>35</sup> Valor has provided no evidence suggesting an inability to return to these rates.

13. Valor attributes its low earnings for study area #1164 in 2001 to (1) the general downturn of the economy, and (2) an eight percent increase in capital expenditures in accordance with the New Mexico state commission's requirement.<sup>36</sup> Nothing in the record supports a conclusion that such conditions are so unusual as to warrant our intervention. We are not persuaded by Valor's contention that a decrease in profits below the low-end adjustment level for a single year should entitle the company to a waiver of the application of the X-factor. A mere decrease in profits is not sufficient by itself to demonstrate a significant change in a company's financial health to warrant suspension of our price cap rules.<sup>37</sup> Even if we accept Valor's claims that flattening of demand attributed to the general downturn of the economy contributed to the low earnings, there is nothing in the record to suggest that this economic downturn will continue in the future, or will significantly affect Valor's ability to achieve greater productivity through improved operating efficiencies and innovations. Similarly, we do not find a mandated eight percent increase in capital expenditures so burdensome or unusual that we should suspend our price cap rules. Accordingly, we find that Valor New Mexico fails to satisfy the waiver standard established by the Commission and the courts.

14. *Valor Texas.* We find that Valor Texas presents unique circumstances and shows good cause for waiver. Valor acquired two partial study areas from GTE in 2000, and it consequently had incomplete cost information at the time of acquisition (e.g., maintenance personnel did not come with the study areas).<sup>38</sup> Valor also purchased some remotes switches whose host switches remained the property of GTE, thus requiring Valor to incur additional costs to connect these switches to the rest of its network.<sup>39</sup> In both years of operation, Valor Texas's new stand-alone study area has required a substantial low-end adjustment: it

<sup>33</sup> A rulemaking is generally a better and more effective procedure for considering changes to industry-wide policy than is the review of a waiver petition. See *Stockholders of Renaissance Communications Corp. and Tribune Co.*, 12 FCC Rcd 11866, 11887-88, para. 50 (1997) (citing *Community Television of Southern California v. Gottfried*, 459 U.S. 498, 511 (1983)).

<sup>34</sup> Valor New Mexico seeks the waiver for its study area #1164, but not for study area #1193. See Petition at ii.

<sup>35</sup> Earnings for study area #1164 (including when owned by GTE) are as follows: 2001 = 8.39%, 2000 = 20.57%, 1999 = 28.68%, 1998 = 47.21%, 1997 = 42.53%, and 1996 = 47.29%. Earnings for study area #1193 (including when owned by GTE) are as follows: 2001 = 11.45%, 2000 = 13.41%, 1999 = 39.34%, 1998 = 31.79%, 1997 = 24.21%, and 1996 = 24.60%.

<sup>36</sup> See Petition at 3.

<sup>37</sup> A number of accounting practices unrelated to a company's ability to earn, e.g., short-duration capital expenditures, write offs, and accounting flexibility, may decrease profits in the short term.

<sup>38</sup> Petition at 2.

<sup>39</sup> See *Reshaping Rural Telephone Markets, Financial Perspectives on Integrating Acquired Access Lines*, Legg Mason Research, at 100 (Fall 2001).

earned 6.7 percent in 2000 and 5.7 percent in 2001.<sup>40</sup> Absent relief, Valor expects to require a low-end adjustment again in 2002.<sup>41</sup> In addition, Valor Texas incurred extraordinary costs as a result of a severe ice-storm in December 2000, which contributed to substantial capital expenditures in 2000 and 2001.<sup>42</sup> Valor Texas had capital expenditures of \$56.6 million in calendar year 2001, an amount roughly 40 percent greater than what it anticipates spending in 2002 and later years.<sup>43</sup>

15. The Commission observed in the *CALLS Order* that the low-end adjustment has only rarely been invoked.<sup>44</sup> Consecutive low-end adjustments are even more unusual.<sup>45</sup> Nevertheless, we note that the existence of consecutive years of low earnings is by itself an insufficient basis for concluding that a company cannot increase its productivity and operate more efficiently than it did in the past. In addition to the low earnings, however, we note that, while all other study area rates of return were set at 11.25 percent at the start of the price cap regime, Valor's new stand-alone area, formed from two partial study areas in 2000, was not.<sup>46</sup> Ideally, we would prefer more than two years of data to support Valor's request, but we conclude that Valor should not have to wait additional years to show that its situation will not improve absent our intervention. We also find that the above circumstances -- Valor Texas's consecutive low earnings, acquisition of partial study areas, and the incurrence of substantial capital expenditures due to circumstances beyond Valor's control -- suggest that the application of the low-end adjustment mechanism without additional relief has been insufficient to free Valor from a cycle of consistent low earnings requiring annual low-end adjustments, and could compromise Valor's ability to maintain current levels of service in Texas should they persist. Under these circumstances, we find that the application of the X-factor would be unduly burdensome this year.

16. We are nevertheless concerned about the impact any relief we grant may have on long-term rates. We note that waiving the application of the X-factor, even one time, results in rates permanently higher than they would be had the X-factor been applied, and further delays elimination of the CCL charge. Therefore, instead of granting a permanent waiver of the X-factor this year, we will defer the application of this year's X-factor adjustment to the X-factor free year that begins July 1, 2004. We believe that deferring the application of the X-factor will serve the public interest and will not undermine the policy objective of the rule in question. This action will, as of July 1, 2004, reduce Valor Texas's rates roughly to the level intended by the *CALLS Order*, thereby alleviating concerns that the relief may significantly hinder elimination of the CCL charges. The deferral should also give Valor sufficient time to improve its situation. We note, however, that this relief is for the application of (X – GDP-PI) portion of the formula rather than just the X-factor and that, as such, Valor will not be able to adjust for inflation this year.<sup>47</sup>

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<sup>40</sup> Petition at 2.

<sup>41</sup> Valor's Reply to AT&T's Opposition at 5 (filed May 17, 2002) (Valor Reply).

<sup>42</sup> Petition at 2-3.

<sup>43</sup> See *id.* at 3. See also Letter from Tonya Rutherford, Latham & Watkins, to Marlene H. Dortch, Secretary, FCC (filed June 3, 2002).

<sup>44</sup> See *CALLS Order*, 15 FCC Rcd at 13038, para. 182.

<sup>45</sup> Valor states that there have only been three instances of study areas taking low-end adjustments in consecutive years. Valor Reply at 8, n. 21.

<sup>46</sup> Prior to price cap regulation, all LECs were subject to rate-of-return regulation, with an 11.25% prescribed rate of return, so that this rate of return was reflected in the initial price cap rates for all study areas. See *LEC Price Cap Order*, 5 FCC Rcd 6786 (1990). See also *CALLS Order*, 15 FCC Rcd at 12968, para. 16.

<sup>47</sup> Valor states that, even though it seeks an X-factor set at "zero," it has no objection to setting the X-factor equal to inflation. Letter from Tonya Rutherford, Latham & Watkins, to Marlene H. Dortch, Secretary, FCC (filed May 30, 2002).

17. We conclude that Valor Texas has shown good cause and satisfies the waiver standard established by the Commission and the courts. We believe that the public interest is served by granting this limited relief, which affords Valor Texas an opportunity to increase its earning and to support the provision of the services customers need and expect. At the same time, it does not permanently increase Valor Texas's CMT rates. We note that, if needed and supported by the record, we can consider additional relief in the future.

#### **IV. ORDERING CLAUSES**

18. Accordingly, IT IS ORDERED that, pursuant to section 1.3 of the Commission's rules, 47 C.F.R. § 1.3, Valor's petition for waiver of application of the X-factor under section 61.45(b)(1)(i) of the Commission's rules, 47 CFR § 61.45(b)(1)(i), IS DENIED IN PART AND GRANTED IN PART.

19. IT IS FURTHER ORDERED that this Order is effective upon release.

FEDERAL COMMUNICATIONS COMMISSION

Dorothy T. Attwood  
Chief, Wireline Competition Bureau